



OFFICE OF  
INSURANCE COMMISSIONER

In the Matter of	)	No. G05-13
	)	
The Financial Examination of	)	FINDINGS, CONCLUSIONS,
<b>PEMCO INSURANCE COMPANY</b>	)	AND ORDER ADOPTING REPORT
	)	OF
A Domestic Insurer.	)	FINANCIAL EXAMINATION

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**BACKGROUND**

An examination of the financial condition of **PEMCO INSURANCE COMPANY** (the Company) as of December 31, 2003, was conducted by examiners of the Washington State Office of the Insurance Commissioner (OIC). The Company holds a Washington certificate of authority as a stock insurer. This examination was conducted in compliance with the laws and regulations of the state of Washington and in accordance with the procedures promulgated by the National Association of Insurance Commissioners and the OIC.

The examination report with the findings, instructions, and comments and recommendations was transmitted to the Company for its comments on May 6, 2005. The Company's response to the report is attached to this order only for the purpose of providing convenient review of the response.

The Commissioner or a designee has considered the report, the relevant portions of the examiners' work papers, and submissions by the Company.

Subject to the right of the Company to demand a hearing pursuant to Chapters 48.04 and 34.05 RCW, the Commissioner adopts the following findings, conclusions, and order.

**FINDINGS**

Findings in Examination Report. The Commissioner adopts as findings the findings of the examiners as contained in pages 1 through 16 of the report.

PEMCO INSURANCE COMPANY  
Order Adopting Examination Report  
May 18, 2005

Mailing Address: P.O. Box 40255 • Olympia, WA 98504-0255  
Street Address: 5000 Capitol Blvd. • Tumwater, WA 98501

## CONCLUSIONS

It is appropriate and in accordance with law to adopt the attached examination report as the final report of the financial examination of **PEMCO INSURANCE COMPANY** and to order the Company to take the actions described in the Instructions and Comments and Recommendations sections of the report. The Commissioner acknowledges that the Company may have implemented the Instructions and Comments and Recommendations prior to the date of this order. The Instructions and Comments and Recommendations in the report are an appropriate response to the matters found in the examination.

## ORDER

The examination report as filed, attached hereto as Exhibit A, and incorporated by reference, is hereby ADOPTED as the final examination report.

The Company is ordered as follows, these being the Instructions and Comments and Recommendations contained in the examination report on pages 1-5.

1. Pursuant to RCW 48.05.370, the Company is ordered to obtain and review conflict of interest declarations from appropriate personnel and to report the results to the Company's Board of Directors, as required by the Conflict of Interest Policy. Instruction 1, Examination Report, page 1.
2. The Company is ordered to correct all deficiencies and execute a revised or amended custodial agreement with US Bancorp pursuant to NAIC Annual Statement requirements as noted in WAC 284-07-050(2) and adherence to the NAIC Financial Condition Examiner's Handbook. Instruction 2, Examination Report, page 2.
3. The Company is ordered to comply with RCW 48.05.370, which states that officers and directors "...shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions". This should include creating an Audit Committee which would be responsible for ensuring that the Internal Audit Department adequately covers significant, sensitive control areas and avoids even the appearance of subjectivity by devoting all its resources to performing internal audits. Instruction 3, Examination Report, page 4.
4. Pursuant to RCW 48.05.073 which requires conformity with NAIC accounting practices, RCW 48.05.250 which requires a "true statement" in the NAIC form, and SSAP #2, paragraph 6 & 7, which defines drafts and checks, the Company is ordered to follow the NAIC Annual Statement Instructions and SSAP when preparing its annual statement and to record the claim payments as checks. Instruction 4, Examination Report, page 4.

5. The Company is ordered to comply with RCW 48.05.250 and file a true statement of its financial conditions, transactions and affairs; with RCW 48.05.073 which requires the filing of its financial statements in accordance with AP&P; and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions and AP&P. Instruction 5, Examination Report, page 5.
6. Pursuant to RCW 48.05.370, which states that "Officers and Directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions," the Company is ordered to develop preventive controls in its claim processing and to establish procedures to prohibit employees from processing claims or accounts receivable in which they have an interest. Instruction 6, Examination Report, page 4.
7. The Company is ordered to immediately consider enhancing its control over cash by depositing unidentified receipts into a bank account. Comments and Recommendations 1, Examination Report, page 4.
8. The Company is ordered to consider reviewing and adjusting, if appropriate, the entire subject of corporate governance, internal controls and approval powers. Comments and Recommendations 2, Examination Report, page 4.
9. The Company is ordered to consider taking steps to ensure compliance with established control procedures for establishing and monitoring reserves on open claims. Comments and Recommendations 3, Examination Report, page 5.
10. The Company is ordered to consider analyzing, developing a rationale for, and documenting its process for approval of its reinsurance contracts. Comments and Recommendations 4, Examination Report, page 5.
11. The Company is ordered to consider performing a periodic review of its investment custodian to ensure that it is meeting expectations. Comments and Recommendations 5, Examination Report, page 5.

IT IS FURTHER ORDERED THAT, the Company file with the Chief Examiner, within 90 days of the date of this order, a detailed report specifying how the Company has addressed each of the requirements of this order.

ENTERED at Tumwater, Washington, this 18<sup>th</sup> day of May, 2005.

A handwritten signature in black ink, appearing to read "Mike Kreidler", written in a cursive style.

MIKE KREIDLER  
Insurance Commissioner



325 Eastlake Avenue East  
PO Box 778  
Seattle, WA 98111-0778

May 5, 2005

Mr. James T. Odiorne, CPA, JD  
Deputy Insurance Commissioner  
State of Washington  
Office of the Insurance Commissioner  
P.O. Box 40259  
Olympia, WA 98504-0259

RE: Report of Examination as of December 31, 2003 – PEMCO Insurance Company

Dear Deputy Commissioner Odiorne:

We have received the draft of the referenced report of examination and completed our review of the material presented. Overall, we are pleased with the report and look forward to its formal adoption.

In response to your request for our comments on the draft, the following responses are offered in regards to the INSTRUCTIONS listed on pages 1 - 4. Please include them with the final examination report that will be made publicly accessible.

1. Conflict of Interest – RCW 48.05.370 states, "Officers and directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions." In order to monitor compliance with this statute, the Company is instructed to obtain and review conflict of interest declarations from appropriate personnel and to report the results to the Company's Board of Directors, as required by the Conflict of Interest Policy.

**RESPONSE:**

Our policy is to have all directors, officers, and key employees submit a signed Conflict of Interest Statement each year. During the exam, all Conflict of Interest Statements were brought up to date.

Mr. James T. Odiome, CPA, JD  
State of Washington  
Office of the Insurance Commissioner  
May 5, 2005  
Page 2 of 3

2. Custodial Agreement - The Company is required to follow the NAIC's Annual Statement requirements as noted in the WAC 284-07-050(2). Adherence to the NAIC Financial Condition Examiner's Handbook is one of these requirements. The Company is instructed to correct all deficiencies above and execute a revised or amended custodial agreement.

**RESPONSE:**

The custodial agreement was revised effective June 1, 2004 to adhere to the NAIC Financial Condition Examiner's handbook. The OIC has reviewed and accepted the revised agreement.

3. Internal Audit Department - The Company is instructed to comply with RCW 48.05.370, which states that officers and directors "...shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions". This should include creating an Audit Committee which should be responsible for ensuring that the Internal Audit Department covers significant, sensitive control areas and avoids even the appearance of subjectivity by devoting all of its resources to performing internal audits.

**RESPONSE:**

While RCW 48.05.370 does not mandate the creation of an audit committee, the board of directors will continue to evaluate the existing internal audit environment, and ways to support the internal audit function. The Company's parent is currently in the process of hiring a Director of Internal Audit, who is expected to assist in that evaluation and to elevate the importance and visibility of the internal audit function.

4. Drafts versus Checks - Pursuant to RCW 48.05.073 which requires conformity with NAIC accounting practices, RCW 48.05.250 which requires a "true statement" in the NAIC form, and SSAP #2, paragraph 6 & 7, which defines drafts and checks, the Company is instructed to follow the NAIC Annual Statement Instructions and SSAP when preparing its annual statement and to record the claim payments as checks.

**RESPONSE:**

During the examination our claim payment instruments were evaluated and determined to be checks, not drafts. Therefore, the Company's 2004 Annual Statement filing correctly includes the claim payments as checks (Balance Sheet pages 2 & 3), as will future filings.

Mr. James T. Odlome, CPA, JD  
State of Washington  
Office of the Insurance Commissioner  
May 5, 2005  
Page 3 of 3

5. NAIC Annual Statement Preparation (Intercompany Taxes) - The Company is instructed to comply with RCW 48.05.250 and file a true statement of its financial conditions, transactions and affairs; with RCW 48.05.073 which requires the filing of its financial statements in accordance with AP&P; and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions and AP&P.

**RESPONSE:**

The Company's 2004 Annual Statement filing correctly displays the Federal Income Tax Receivables and Payables as separate line items from intercompany receivables and payables (Balance Sheet pages 2 & 3), as will future filings.

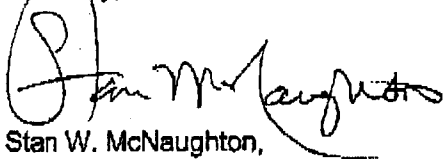
6. Preemptive Controls Over Claims Processing and Employee Transactions - Pursuant to RCW 48.05.370, which states that "Officers and Directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions," the Company is instructed to develop preventive controls in its claim processing and to establish procedures to prohibit employees from processing claims or accounts receivable in which they have an interest.

**RESPONSE:**

We strengthened our controls on field checks in March of 2005 with the implementation of a new processing system. Field checks will be gradually phased out. Adjuster transaction reports are reviewed daily by their supervisors. Claim assignment procedures and controls are in place assuring no claims department employee works on or has access to a claim in which they have an interest.

If you have further questions regarding these items or anything else in regards to our report of examination for the period ended December 31, 2003, please do not hesitate to contact me

Sincerely,



Stan W. McNaughton,  
President  
PEMCO Insurance Company